INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statutes involved	2
Statement of facts	3
Specification of errors to be urged	5
Summary of argument	5
Argument:	
I. Depreciation is properly allowed only in cases where the taxpayer has made a capital outlay and to the extent of original cost in the case of property acquired after March 1, 1913	7
II. The decision of the Circuit Court of Appeals was in error in allowing a deduction to be taken under the leases, when it was possible that they would never require any capital expenditures to be made	12
III. The construction of the section contended for by the commissioner has been followed without change under the various revenue acts and the action of Congress, in reenacting that section, amounts "to an implied legislative approval of the executive construction of the statute	22
Conclusion	25

CITATIONS

Cases:

Belt Railway Company of Chicago v. *Commissioner*, 9 B. T. A. 304	23
Brevoort Hotel Co., Appeal of, 1 B. T. A. 132	23
Cryan v. *Wardell*, 263 Fed. 248	24
Duffy v. *Central R. R.*, 268 U. S. 55	6, 10, 19, 20, 25
Miller v. *Gearin*, 258 Fed. 225; certiorari denied, 250 U. S. 667	24
National Lead Co. v. *United States*, 252 U. S. 140	25
Ostheimer, William J., Appeal of, 1 B. T. A. 18	23
Ralston Car Co. v. *Ralston*, 112 Ohio St. 306	11
Rawson v. *Brown*, 104 Ohio St. 537	11
Smith v. *Harrison*, 42 Ohio St. 180	11
Stephenson v. *Haines*, 16 Ohio St. 478	11
Taylor v. *De Bus*, 31 Ohio St. 468	11
United States v. *Bailey*, 9 Pet. 238	25
United States v. *Ludey*, 274 U. S. 295	6, 7, 25
Wilhelm Co., A., Appeal of, 6 B. T. A. 1	23
Worthington v. *Hewes & McCann*, 19 Ohio St. 66	11

Statutes: Page

Revenue act of 1918, c. 18, sec. 214, 40 Stat. 1057 ..... 2, 25
Revenue act of 1921, c. 136, sec. 214, 42 Stat. 227 25
Revenue act of 1924, c. 234, 43 Stat. 253—
Section 204 (c) (U. S. C., title 26, sec. 935 (c)) 8
Section 214 (a) (8) (U. S. C., title 26, sec. 955) 25
Revenue act of 1926, c. 27, 44 Stat. 9—
Section 204 (c) (U. S. C., App., title 26, sec. 935 (c)) ... 8
Section 214 (a) (8) (U. S. C., App., title 26, sec. 955) .. 25
Revenue act of 1928, c. 852, 45 Stat. 791—
Section 23 (k) 25
Section 114 (a) 8
Miscellaneous:
Office Decision 516, 2 Cumulative Bulletin 112 23
Office Decision 1014, 5 Cumulative Bulletin 151 23
Treasury Regulations 33, article 140 25
Treasury Regulations 45—
Article 48 24
Article 109 24
Article 161 22
Article 164 22
Treasury Regulations 62, article 109 24
Treasury Regulations 65, article 110 24
Treasury Regulations 69, article 110 24

In the Supreme Court of the United States

OCTOBER TERM, 1928

No. 482

HARRY H. WEISS, COLLECTOR OF INTERNAL REVENUE,
petitioner

v.

J. HARRY WIENER

No. 483

C. F. ROUTZAHN, COLLECTOR OF INTERNAL REVENUE,
petitioner

v.

J. HARRY WIENER

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR PETITIONERS

OPINIONS BELOW

The opinion of the United States District Court for the Northern District of Ohio (R. 43) is reported in 17 F. (2d) 650. The opinion of the Circuit Court of Appeals (R. 59) is reported in 27 F. (2d) 200.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on June 30, 1928. (R. 58.) Petition for certiorari was filed September 28, 1928. Certiorari was granted October 29, 1928. (R. 62.)

Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In the determination of his taxable net income under the Revenue Act of 1918, is a taxpayer entitled to any deduction under Section 214 (a) (8) of that Act on account of the exhaustion, wear and tear of buildings occupied by him under ninety-nine year leases, renewable forever, where such leases were acquired after March 1, 1913, and cost the taxpayer nothing except a stipulated annual rental, and where the buildings in question were not erected or paid for by the taxpayer?

STATUTES INVOLVED

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1066, 1067:

> SEC. 214. (a) That in computing net income there shall be allowed as deductions:
>
> (1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or

other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity;

* * * * *

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

* * * * *

STATEMENT OF FACTS

These two cases were instituted by the respondent in the United States District Court for the Northern District of Ohio to recover income taxes for the years 1918, 1919, and 1920, paid under protest, and, since they both involved the same question of law, were disposed of as a single case. (R. 1, 12.) Judgments were entered in favor of the Government. (R. 11, 22.) The cases were taken on writs of error to the Circuit Court of Appeals, Sixth Circuit, where they were heard together. The Circuit Court of Appeals reversed the judgments of the lower court. (R. 58.) This Court granted certiorari on October 29, 1928.

During the years 1918, 1919, and 1920 the taxpayer was the owner of thirteen leases for ninety-nine years, renewable forever. These leases were all acquired after March 1, 1913, and the lessee paid nothing for them. At the time the leases were

made there were standing on the premises certain buildings which had been erected by and at the cost of the lessor. These buildings were sublet by the lessee to tenants, and the income thus produced was included by him in his income tax returns for the years 1918, 1919, and 1920. In calculating his net income the respondent was allowed to deduct as business expenses all sums spent as repairs on said buildings. (R. 24–25.)

The covenants contained in these several leases vary. In four of them (H, I, J, and L; R. 29–32), there is a covenant to keep and maintain buildings on the premises. In all of the leases there is a provision that in case of a destruction by casualty the buildings shall be replaced. In some cases it is specifically provided that the lessee shall furnish funds in addition to the insurance money if necessary to restore the property. In other cases it is merely provided that the insurance money shall be applied to the restoration. In seven of the leases (A, B, C, E, H, I, and L; R. 26–32) it is provided that the destruction of the buildings does not terminate the leases. In three of the leases (D, F, and G; R. 27–29) the lessee is obligated to erect new buildings at specified costs. In five of the leases (C, E, F, H, and L; R. 27–29, 32) the lessee is given an option to purchase. Seven of the leases (D, E, F, G, J, K, and N; R. 27–33) were surrendered, canceled, or assigned.

In so far as the lessee had made any expenditures for repairs, improvements, or replacements, such expenditures were taken into account in determining his taxable income. (R. 25.)

The taxpayer claims a right to deduct from his gross income in each year, an aliquot part of the value at the time he acquired the leases of the buildings standing on the leased property. This, he asserts, represents the depreciation of those buildings. The Government contends that any expenditures which he makes under the leases, he may deduct, but that he can not set up a reserve to liquidate his obligations, even if such obligations were fixed.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred in holding that the respondent was entitled to a deduction, under Section 214 (a) (8) of the Revenue Act of 1918, on account of the exhaustion, wear and tear of buildings held by him under ninety-nine year leases, renewable forever, where such leases were acquired after March 1, 1913, and cost the respondent nothing except a stipulated annual rental, and where the buildings in question were not erected or paid for by him.

SUMMARY OF ARGUMENT

The respondent has asked that he be allowed deductions for exhaustion, wear and tear on property which required no capital outlay by him and as to which his future liability is indefinite and specula-

tive. The decision of the Circuit Court of Appeals, in allowing the deductions asked, is in direct conflict with the decision of this Court in *United States* v. *Ludey*, 274 U. S. 295. It was there determined that depreciation was a deduction from original cost. (P. 300.) As there has been no original cost in the instant case, it must follow that there can be no allowance.

Neither is the instant decision in harmony with the decision of this Court in *Duffy* v. *Central R. R.*, 268 U. S. 55. It was there held that an expense incurred by a lessee in replacing an old pier with a new one could be recovered only by taking deductions for depreciation after the expense had been incurred. Considering these two cases together, it becomes apparent that the allowance for exhaustion must await the capital expenditure.

The decision is not factually sound in that the Circuit Court of Appeals has assumed that under all the leases the taxpayer would be under obligations to replace the old buildings under lease with new buildings during the period of his leases. Neither the leases nor the other facts in the case support this premise. (R. 24–42.)

Beyond this, however, the decision of the Circuit Court of Appeals is in conflict with the long continued departmental construction of the provisions of the Revenue Act of 1918 here in question and similar provisions in earlier and subsequent Acts. Articles 164 and 165 of Regulations 45. It is also

in direct conflict with the Revenue Act of 1924, Section 204 (c) of the Revenue Act of 1926, and Section 204 (c) of the Revenue Act of 1928, which prescribe cost as the basis for the determination of allowances for depreciation.

ARGUMENT

I

DEPRECIATION IS PROPERLY ALLOWED ONLY IN CASES WHERE THE TAXPAYER HAS MADE A CAPITAL OUTLAY AND TO THE EXTENT OF ORIGINAL COST IN THE CASE OF PROPERTY ACQUIRED AFTER MARCH 1, 1913

Section 214 (a) (8) of the Revenue Act of 1918 allows as a deduction in computing net income "a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business." The regulations of the Commissioner of Internal Revenue, promulgated under this and all previous Acts, provided that depreciation allowances should be computed upon the basis of the cost to the taxpayer of the depreciable property. This method was approved by this Court in the case of *United States* v. *Ludey*, 274 U. S. 295, where it is said (p. 300):

> * * * The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum

> which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide *an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold.* * * *. (Italics supplied.)

The use of cost to the taxpayer as the basis for depreciation allowances is expressly provided for in the Revenue Act of 1928 (Sec. 114 (a)); in the Revenue Act of 1926 (Sec. 204 (c), c. 27, 44 Stat. 9, 16); and in the Revenue Act of 1924 (Sec. 204 (c), c. 234, 43 Stat. 253, 260).

Moreover, in this case it apparently is conceded that the proper basis for the allowance is cost to the taxpayer, the issue arising from the divergent views as to what constitutes the taxpayer's cost under the provision of these leases.

The Circuit Court of Appeals, in reversing the decision of the District Court, has allowed the taxpayer to take deductions for the exhaustion, wear and tear of the buildings occupied by him under long-term leases renewable forever. Up to the time this suit was brought the taxpayer had expended nothing on these buildings, except for repairs and maintenance charges which had been deducted by him from his income. The decision of the Circuit

Court of Appeals is based upon the long terms covered by the leases and the taxpayer's obligations, under the leases, to maintain and restore the buildings in accordance with the provisions thereof. Because of this it is concluded that the value of the buildings at the time of the execution of the leases should be considered as taxpayer's capital investment, and in so far as they are consumed in his business, he should be entitled to allowances for depreciation. (R. 60.) That court has assumed that the investment of the owner or lessor becomes the investment of the lessee, and as such is to be measured by the value of the buildings, regardless of whether the lessee paid anything for the buildings or not. From this premise it follows that the taxpayer may take allowances for depreciation which in the aggregate will suffice to *provide an amount equal to this value*. (R. 60.)

It has reasoned that, since taxpayer is responsible for the buildings and must keep them in the condition in which they were when he took the leases, he should be allowed to take care of their exhaustion by establishing an account free from income taxes in the nature of a reserve for depreciation. In other words, the Circuit Court of Appeals has taken the position that since the taxpayer is using the capital, and since, if he is to continue to use it, he must be prepared to replace it, he is entitled to depreciation. (R. 60.) This seems to amount to saying that the property is to be treated

as the lessee's because the lessee has covenanted to ultimately return the property.

The Circuit Court of Appeals does not take the position, in computing his depreciation, that the sums which the taxpayer may have to expend *in the future* are to be regarded as his cost. Nor does it hold that the cost incurred by taxpayer will be commensurate with the value of the buildings. (R. 59.) Moreover, the lessee's obligations under the leases clearly foreclose any such contention.

The allowance here is for a depreciation which is entirely anticipatory and speculative. It must clearly be distinguished from the case where the lessee has actually been required to make outlays from his own capital. In *Duffy* v. *Central R. R.*, 268 U. S. 55, this Court has said that the lessee might recover back such expenditures through depreciation. The expenditures which the taxpayer there attempted to deduct as ordinary and necessary expenses, however, had actually been made. Applying the rule there laid down, a taxpayer can not take a deduction in anticipation of a future expense and another after the expense is incurred. Yet under the theory developed by petitioners, and taken by the Circuit Court of Appeals, it would be difficult to avoid this duplication.

Neither does the decision seem to depend upon the character of the title of the lessee, who holds under ninety-nine-year leases renewable forever. It is true that by the statutes of Ohio a permanent

leasehold estate has many of the incidents of a fee simple estate. *Ralston Car Co.* v. *Ralston*, 112 Ohio St. 306; *Stephenson* v. *Haines*, 16 Ohio St. 478; *Worthington* v. *Howes & McCann*, 19 Ohio St. 66. The Supreme Court of Ohio has expressly held, however, that such an estate is not a fee simple and that the possession of the lessee is the possession of the lessor. *Rawson* v. *Brown*, 104 Ohio St. 537; *Taylor* v. *De Bus*, 31 Ohio St. 468; *Smith* v. *Harrison*, 42 Ohio St. 180. It is not believed, therefore, that the character of the lessee's title under the leases has any substantial bearing upon the principles involved in this case.

The Circuit Court of Appeals, having held that the only requisite (except that the property be used in the business) is that the taxpayer be "the one who must suffer and bear the burden of the loss or depreciation" and that the property used in the business is the "capital of the one who is responsible for the property * * * and who also uses and consumes it in his business," proceeds to the conclusion that the lessee is entitled to recover the *value* of the standing buildings because "he is responsible for the buildings, must keep them in the condition in which they were when he took the leases, and if they are consumed, as they will be in his business, or are destroyed or removed, he must replace them." This conclusion ignores the fact that, under any view of the case, the future replacement investment of the lessee is not and is never

likely to be the same as the value of the buildings at the time the leases were acquired. His investment is the cost of repairs and maintenance which he deducts. His obligation under the lease is not to return to the lessor a sum of money equal to the present value of the buildings but is to return a depreciated building having a certain value. The cost of fulfilling that obligation bears no relation to the amount which the court permits the taxpayer to set aside for its fulfillment.

II

THE DECISION OF THE CIRCUIT COURT OF APPEALS WAS IN ERROR IN ALLOWING A DEDUCTION TO BE TAKEN UNDER THE LEASES, WHEN IT WAS POSSIBLE THAT THEY WOULD NEVER REQUIRE ANY CAPITAL EXPENDITURES TO BE MADE

The conclusion which the court reaches also proceeds on an erroneous conception of the effect of depreciation. The court assumes that it will be necessary to replace the buildings *in toto* at least once and perhaps several times during the terms of the leases. In dealing with depreciation allowances it is assumed that any given capital asset will have a useful life of a certain number of years. This assumption is predicated upon the further assumption that nothing will be expended on upkeep of the property other than ordinary repairs—that no capital expenditures or replacements will be made. But each replacement or extraordinary expenditure chargeable to the capital investment partially renews it, so that, at the end of the as-

sumed useful life of the entire building, it will not have been actually consumed. Hence it does not necessarily appear that the lessee in this case will have to replace *in toto* any building. He is required to maintain from day to day the buildings in such condition that they will have a value each day equal to the value assigned to them in the lease. The lessee covenants "*at all times* during the term of this lease to maintain on the premises above described a building or buildings, *the fair cost or value* of which shall not be less" than a stated sum, the intention of the parties being "that the lessee shall keep and maintain the *buildings now on said premises* in like condition as the same now are in." (Exhibit B; R. 33, 36.) (Italics supplied.) Changing economic conditions as well as wear and tear of the buildings must be considered in determining the extent of the lessee's liability. Consequently, the cost of fulfilling this obligation can not be foreseen. Its full measure is the actual expenditure made in its performance.

And that this was the intent of the parties is clear. As quoted above, the only lease appearing in full in the record expressly says so. All of the provisions of the leases which require maintenance and which permit removal (H, I, and L, R. 29–32) point to the fact that in no case did the lessor look to the credit of the lessee. The leases provide for the payment in advance of fixed rentals. They provide that the lessee shall keep the buildings fully insured. They provide

that in the event of voluntary destruction a bond shall be given before the destruction is commenced. Clearly, then, the lessor did not contemplate that the lessee should allow these buildings at any time to become exhausted. The value must be maintained from day to day. Resultantly, if the covenants are fulfilled, the allowances made by the Commissioner for "ordinary and necessary expenses" will fully compensate the lessee for all the expenditures which he makes under this lease at the time he makes them.

The conclusion of the Circuit Court of Appeals is erroneous for the further reason that it is assumed that the leases impose certain obligations upon the lessee which in fact are not imposed. The court says (27 F. (2d) 200; R. 59):

> The leases required the lessee to maintain on the premises buildings of the fair cost or value of not less than a stipulated amount (in some cases greater and in none less than the value of the existing buildings), to keep the buildings in "like condition as the same now are in," and, in case of their destruction or removal from any cause, to replace them with buildings of the fair cost or value of a stated sum (equal to or greater than the value of the existing buildings). In some of the leases there were covenants to erect new buildings at future dates. * * *. (R. 59.)

and, based on this summary of the requirements of the leases, the court further says (p. 201; R. 60), as the reason for its decision:

> * * * He (the lessee) is responsible for the buildings, must keep them in the condition in which they were when he took the leases, and, if they are consumed, as they will be in his business, or are destroyed or removed, he must replace them. * * *. (R. 60.)

A consideration of the provisions of these leases, it is submitted, shows first that the provisions summarized do not appear in all of the leases, and secondly, that the responsibilities placed upon the lessee are not as supposed by the learned court below. The covenants of the leases with respect to maintenance, replacements, and additions fall into one of four classes:

The first class consists of covenants requiring the lessee to replace the buildings which he voluntarily tears down (all leases except J); the second class embraces those which require the lessee to replace buildings accidentally destroyed (all leases); the third class relates to the necessity of maintaining the present buildings (Leases H, I, J, L; R. 29–32); and the fourth class obligates the lessee to erect new buildings at specified costs (Leases D, F, G; R. 27–29).

Clearly under covenants of the first class there can be no obligation upon the taxpayer until he razes the building, and the assumption of this obligation is entirely optional with him. Obviously, taxpayer would not be entitled to build up a reserve to take care of these obligations under any theory recognized by the taxing laws.

The covenants of the second class, that is, those relating to the restoration of buildings in the case of destruction by casualty, are to be found in all of the leases but are varied in their terms. All of the leases (Lease E, R. 28, is, perhaps, an exception) require the lessee to keep the buildings insured. Leases A and B (R. 26) provide that the buildings shall be restored to their former condition. Leases H, I, L, and perhaps J (R. 29, 30, 31, 32) require the lessee to supply any deficiency over and above the amount of insurance received required to restore the buildings. Leases C, D, G, and N (R. 27, 29, 32–33) merely require that the proceeds from the insurance on the buildings shall be used in restoring them. Leases E, F, J, and K (R. 28, 30–31) provide that the insurance shall be paid to a trustee who shall use it in restoring the buildings. Lease J. (R. 31), since it requires the maintenance of a building of a specified value, may, perhaps, require additional expenditures. Thus under these covenants, as found in leases C, D, E, F, G, K, and N, no obligation can possibly arise requiring any investment to be made by the taxpayer. Under the remaining leases, A, B, H, I, L, and perhaps J, the obligation arises only in the event, which may never happen, of the destruction of the buildings by casualty, and then only in the case that the insurance is insufficient to erect buildings of a stated value.

The extent of the capital investment which taxpayer might be required to make under these last five leases can not be foretold or provided against in any reasonable manner. Further, since under

all the leases the insurance is to be used for replacement of the buildings destroyed, taxpayer can not be allowed to accumulate a reserve to take care of these same replacements. Still further, the lessee may have thereafter the full benefit of any expenditure he makes.

The so-called "typical lease" or Lease I, set out as Exhibit B (R. 33–42) as being *representative* of the third class, contains a covenant that the lessee agrees (R. 35–36) "at all times to keep and maintain the buildings and improvements from time to time on said premises in good repair and in proper condition and (except during the periods allowed by this lease for the repairs and alterations or for reconstruction in case of loss or damage to such buildings and improvements or for the erection or construction of a new building or buildings on said premises), at all times during the term of this lease to maintain on the premises above described a building or buildings, the fair cost or value of which shall not be less than seventy thousand dollars ($70,000), it being the intention of the parties hereto that lessee shall keep and maintain the buildings now on said premises in like condition as the same now are in and in case of the removal or destruction from any cause whatsoever of said buildings or improvements, or any part thereon, or any buildings or improvements at any time standing on said premises, that he will replace the same at his own proper cost and expense with a new building or buildings, the character and fair cost and value of

which shall not be less than one hundred thousand dollars ($100,000). * * *."

A consideration of the recitals of the other leases as set out in Exhibit A (R. 26–33) indicates that in but three others, H, J, and L (R. 29–32) are there any covenants of similar purport. Two of these leases, I and J, would seem to require replacements by the lessee as the buildings on the premises are worn out or exhausted through natural and usual depreciation. As has been pointed out, the deduction of these maintenance and replacement items is provided for in the regulations. Lease H contains no express provision for the maintenance of buildings of any specified value, and the lessee is only required to keep the buildings on the premises and those thereafter constructed "in continuous, good, substantial, and tenantable order and repair." (R. 30.) As to this last lease it can not be said that the lessee is under any obligation to replace the building as it becomes exhausted. Lease L expressly excepts from the operation of its covenants "natural depreciation." (R. 32.)

It is true that in leases A, B, C, E, H, I, and L (R. 26–32), it is provided that the destruction of the buildings shall not terminate the leases or relieve the lessee from his obligation to pay rents. (See clause "from whatever cause" appearing in Lease H (R. 30) and the clause "destruction of * * * by fire or otherwise" appearing in Lease L; R. 32.) However, these covenants do not obligate the lessee to replace the buildings, but, at most,

may only create the *practical necessity* of his having to do so in the event that the destruction occurs early in the term.

There are three leases which contain covenants of the fourth class. Lease D (R. 27) requires the lessee to erect a building worth not less than $30,000 within 20 years; lease F (R. 28–29) requires expenditures of $8,000 within 2 years and $25,000 within 6 years for new buildings, and lease G (R. 29) requires an expenditure of $10,000 for permanent improvements without specifying when the same must be expended. The amounts thus required to be expended are not respectively the same as values sought to be set aside.

It thus appears that in the case of but two of the leases, I and J, is the lessee under obligation to replace the exhaustion of the old buildings as they are exhausted, while in three others, D, F, and G, he will be obligated to erect new buildings of stated values in the future. As to both classes of expenditures, whether for replacements or improvements, the allowances, made under the regulations and in accordance with the *Duffy case, supra,* fully return to the taxpayer his capital outlay.

This was the view expressed by the District Court in its opinion, wherein it is said (R. 44):

> * * * It will be time enough to consider the question of allowing depreciation, under any of the conditions above stated, when the contingency shall have happened.

> That such a contingency may never happen is evidenced by the history of the leases in question subsequent to the year 1920. It appears from the agreed statement of facts that leases D and K have been assigned to third persons with the consent of the lessor; that leases E, G, and I have been cancelled and surrendered to the lessor; and the leases N and F have been assigned or released to the lessor. Thus, out of thirteen leases, seven have passed out of the picture without imposing on the plaintiff the obligation to invest any capital. If he had been permitted to retain some part of the net income under the guise of a capital depreciation, he would have merely pocketed an unearned increment.

The Circuit Court of Appeals expressed a contrary view in reversing the District Court by saying (R. 61) that if—

> • • • the leases should be surrendered or cancelled when the buildings first become exhausted, the depreciation fund would be consumed in restoring them, or if they should be surrendered at some later period, when the buildings had once been replaced but had not again become exhausted, the accumulation again would be required to restore them from their partially exhausted condition.

But that this latter argument does not meet the situation which would exist if the leases should be surrendered after five, ten, fifteen, or any other

number of years, is demonstrated by the fact that seven of the leases (D, E, F, G, J, K, and N; R. 27–33) were surrendered, canceled, or assigned before taxpayer was compelled to expend any of the amounts which the court allows to be set aside on account of depreciation. Thus it seems obvious that any depreciation allowed in those years before surrender amounts to capital in the hands of the lessee which he has accumulated tax free. The fact, referred to by the District Court, is that at the time of the trial seven of the leases had "passed out of the picture without imposing on the plaintiff the obligation to invest any capital." (R. 44.) The remaining leases may have passed from the picture immediately thereafter. To these commanding facts the Circuit Court of Appeals gave no weight whatever, and, we believe, placed little, if any, emphasis upon the uncertainty, in every case, and the want of legal necessity, in some cases, by which the replacements were surrounded.

As to those leases which may be or have been surrendered without any expenditure being or having been made, how could the Circuit Court of Appeals defend the right of the taxpayer to retain, tax free, the depreciation allowances, constituting accumulated capital, which are the subject matter around which the controversy in these cases turns? And how could the Government at the time of surrender contend that a taxable gain then resulted from keeping what had been previously earned and received?

The supposed case is not different in principle from the actual cases, and the position taken by the Circuit Court of Appeals appears to be erroneous, certainly as to those leases which have been surrendered and hardly less clearly with respect to those leases which at the time of trial had not been but by this time may be surrendered, cancelled or assigned.

The statute requires at most a *reasonable* allowance for depreciation, and it is submitted that an allowance which is predicated upon a value having no relation unless accidental to the actual investment required of the taxpayer is not under any circumstances a reasonable allowance.

III

THE CONSTRUCTION OF THE SECTION CONTENDED FOR BY THE COMMISSIONER HAS BEEN FOLLOWED WITHOUT CHANGE UNDER THE VARIOUS REVENUE ACTS AND THE ACTION OF CONGRESS IN REENACTING THAT SECTION AMOUNTS "TO AN IMPLIED LEGISLATIVE APPROVAL OF THE EXECUTIVE CONSTRUCTION OF THE STATUTE"

The decision of the Circuit Court of Appeals conflicts with the established departmental construction of the Act in at least three particulars:

It conflicts with Articles 161 and 164 of Regulations 45, which were approved by this Court in the *Ludey case, supra*, in that it allows the taxpayer to deduct from his income amounts said to represent the depreciation of a building in which he has made no investment. The fact, if it be a fact, that he

will have a capital investment in some other building at some later time does not seem to justify a departure from the rule established by the regulations and approved by this Court. It is not permissible to substitute value for cost under the circumstances of this case. The cost to the taxpayer is the cost of the replacement. At the time that that replacement becomes necessary it may cost much more or much less to produce a building which will have at the end of the lease a remaining value equal to the value of the building standing at the beginning of the lease.

It also conflicts with Article 109 of Regulations 45, which article embodies the rule laid down by this Court in the case of *Duffy* v. *Central R. R.*, *supra*, in that the supposed cost is set aside in anticipation of a possible future cost, and thus is not spread over either the life of the property in which the capital is invested, or the *remaining* life of the lease, whichever is shorter. This regulation denies a lessee the right to set up a reserve for estimated future costs. Office Decision 516, 2 Cumulative Bulletin 112; Office Decision 1014, 5 Cumulative Bulletin 151; *Appeal of William J. Ostheimer*, 1 B. T. A. 18; *Appeal of A. Wilhelm Co.*, 6 B. T. A. 1; *Belt Railway Company of Chicago* v. *Commissioner*, 9 B. T. A. 304; cf. *Appeal of Brevoort Hotel Co.*, 1 B. T. A. 132. But the depreciation allowance permitted here is nothing more or less than the

creation of such a reserve and a recovery over the life of a building in which no capital has been invested by the lessee.

Finally, it conflicts with Article 164 of Regulations 45, *supra*, in that it allows the *lessee* to deduct the depreciation which that Article permits the lessor to deduct. Manifestly, both persons can not be at one and the same time the owners of the capital used in the business. The depreciated cost of the improvements erected by a lessee, being income to the lessor at the time of erection, is an expense to the lessee and, as appears from the record in this case, such expense the lessee is permitted by the regulations to take. *Miller* v. *Gearin*, 258 Fed. 225, certiorari denied, 250 U. S. 667; *Cryan* v. *Wardell*, 263 Fed. 248; Article 48, Regulations 45. But no part of the capital already invested by the lessor, i. e., the cost of the standing buildings, should be recoverable by the lessee, in addition to his expenses, merely because he has a right to use the buildings. His cost is what he has to pay, not what the buildings were worth or what they cost someone else.

The provision of Article 109 of Regulations 45, to the effect that the cost of the improvements erected shall be treated as the lessee's capital investment, is likewise found in the succeeding regulations (Article 109, Regulations 62; Article 110, Regulations 65; Article 110, Regulations 69), and in the preced-

ing regulations (Regulations 33, Article 140). At the time that each of these regulations was in effect Congress passed an Act providing for a depreciation allowance in the same language as that used in the Act construed by the respective regulations. Section 214 (a) (8), Revenue Act of 1918, c. 18, 40 Stat. 1057, 1067; Section 214 (a) (8), Revenue Act of 1921, c. 136, 42 Stat. 227, 240; Section 214 (a) (8), Revenue Act of 1924, c. 234, 43 Stat. 253, 270 (U. S. C., Title 26, Sec. 955), Section 214 (a) (8), Revenue Act of 1926, c. 27, 44 Stat. 9, 27 (U. S. C. App., Title 26, Sec. 955 c; Section 23 (k), Revenue Act of 1928, c. 852, 45 Stat. 791, 800.

Congress is presumed to have passed these Acts with knowledge of the then existing executive construction of the statute (*United States* v. *Bailey*, 9 Pet. 238, 256), and its repeated reenactment of the provision, without change, amounts "to an implied legislative recognition and approval of the executive construction of the statute" (*National Lead Co.* v. *United States*, 252 U. S. 140, 146).

CONCLUSION

The decision of the Circuit Court of Appeals is in direct conflict with the regulations of the Commissioner promulgated under the 1918 Act, and earlier and subsequent Acts, and the decisions of this Court in *United States* v. *Ludey*, 274 U. S. 295; *Duffy* v. *Central R. R.*, 268 U. S. 55. It is therefore respectfully submitted that the decision of the Cir-

cuit Court of Appeals is erroneous and should be reversed and the judgment of the District Court should be affirmed.

Respectfully submitted.

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